1/16/15

Dear Clients & Friends,

2014 was a mixed year for U.S. and global financial markets. While the S&P 500 Index was one of the best performing stock markets in the world in 2014 (+ 13.7%), other markets including the U.S. small cap Russell 2000 (+4.5%), Europe MSCI EAFE (-4.9%), MSCI Emerging Markets (-2.2%), HFRX Global Hedge Fund Index (-0.58%) and S&P GSCI Commodities (-33%) didn't fare nearly as well.

Particularly frustrating to our value-oriented strategy was that momentum strategies outperformed value strategies in 2014 by a wide margin. The cheapest 10% of stocks (as measured by low price/book value) appreciated just 1.5% while the most expensive (high price/book ratio) stocks went up 15%. When just a few growth stocks lead the pack, it creates a tough environment for stock pickers. According to Morningstar, just 13% of active large-cap managers beat the S&P 500 this year. Although our value-oriented strategies have yielded great results over the long term and we know our strategy can't outperform every year, we are disappointed that our portfolios didn't perform better. We think 2015 will be a much better year.

We are optimistic for stocks in 2015. We think a lot of the positive trends that occurred last year will continue with a few new ones on top. Similar to last year, 1) stocks still look much more attractive than bonds on a relative valuation basis, 2) the Federal Reserve is still implementing accommodative monetary policies, and 3) market momentum remains strong. In addition, a strong U.S. dollar should attract assets from overseas and dramatically lower oil prices should provide a huge boost to the consumer.

The most common question we've gotten in the last few weeks surrounds the implications of falling oil prices. While not good for energy company profits, falling oil prices are very good for the U.S. consumer. If gasoline prices stay near $2 a gallon for 2015, the economy will see a net savings of $750 per household. Lower oil should accelerate economic growth to 3.8% in the next two years with oil at $40 a barrel, compared with 3% at $84, an Oxford Economics study found. Historically, the S&P 500 has appreciated 19% annually when oil prices have declined over the prior 6 month period vs. just 1% when they were rising.

What's our strategy for achieving great returns this year? We will continue to do in-depth research to find companies worthy of our "Dream Team" portfolio. Our ideal candidate would be a company with strong management, a competitive advantage, strong balance sheet, low valuation, and a catalyst which we think can imminently bring out value. In other cases, a company may have three of the above, but we see a change that could make it great such as new management, activist involvement, or industry consolidation. We are confident a portfolio of such companies gives our clients the best opportunity to grow wealth and achieve superior performance next year and in the long-term.

In the remainder of the letter, I will address three common questions we have received recently:

- Are beaten up oil stocks great value buys?
- Shouldn't the Fed's money printing be causing inflation?
- Won't rising interest rates hurt my stock portfolio?
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If you have any questions or topics you would like me to discuss in future letters, please contact me at tom@eidelmanvirant.com.

Sincerely,

Tom Eidelman, CFA

FREQUENTLY ASKED QUESTIONS
WITH TOM EIDELMAN

Are beaten up oil stocks great value buys?

There has been a major shift in the oil industry. For the past decade, growing oil consumption in China and limited supply led to a decade of soaring oil prices. However, the combination of horizontal drilling and hydraulic fracturing has shifted the debate 180 degrees from one of scarcity to one of abundance. U.S. oil production increased over 60% and increased from approximately 10% to 15% of the world's oil production. Unfortunately, the U.S. energy complex has become a victim of their own success. With new U.S. supply combined with weak demand from Europe and China, oil prices have fallen below the breakeven level for many U.S. exploration & production companies. Oil prices will likely stay below the industry's breakeven levels until excess supply is taken off the market. This typically occurs when the high-cost producers shut down production or go out of business. We will stay on top of the energy industry as falling prices, bankruptcies, uncertainty, and consolidation could create special situation investment opportunities, but we will be wary as the rebalancing of supply and demand could take a while.

We also looked at the 7 major oil plunges since 1986 when oil declined by 40% to see how energy stocks subsequently performed. We were surprised to find out that energy stocks only performed in line with the S&P 500 in the year following the bottom. In other words, even if you knew oil had bottomed, you would have been better off in other sectors like technology, consumer, and material stocks.

In the long run, oil prices will stabilize and the best run, low cost producers and servicers will be profitable again. If we can find such companies at attractive valuations, we will look to add them to our clients' portfolios.

Shouldn't the Fed's money printing be causing inflation?

We think inflation will remain tame in the short run, but we will have to keep a close eye on it. There are both inflationary and deflationary forces occurring all the time. While the Fed has printed an unprecedented $3 trillion, it may not be enough to spark inflation if it can be unwound in a measured fashion. An analogy used to explain this is imagining the government sent every household a check for $30,000, but it was never cashed or spent. Now that the economy has recovered along with rising asset prices, they hope to take those checks back and rip them up.

Globalization and technology should continue to provide good deflationary forces. Some examples are:

- Apple's Iphone has combined thousands of critical items into one small device for just a few hundred dollars. Think about what it would cost to buy a separate miniature phone, TV, computer, flashlight, alarm clock, calendar, MP3 player, photo album, calculator, e-reader, etc. into one device.
- Horizontal drilling technologies have decreased the cost of oil and gas.
- Importing consumer goods from low cost countries has lowered the price of consumer goods at retailers like Wal-Mart.
- Innovation could lower prices in high growth areas where prices have risen like healthcare. Consumers could benefit from new drug discoveries lowering costs of treatments or with medical tourism by flying to another country to get surgical procedures cheaper abroad.

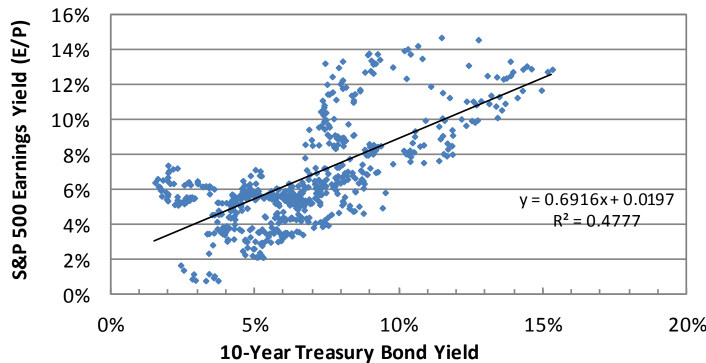
When we look at all these factors, we come to the conclusion that many deflationary forces will continue and that it is good!

Won't rising interest rates hurt my stock portfolio?

We think the most likely scenario this year is for interest rates to rise and for stock valuations to go up. Historical relationships imply that stocks are already pricing in a substantial rise in long-term interest rates. Should rates actually stabilize at a lower-than-expected level (which we view as likely), stocks could appreciate further.

Because stocks and bonds compete with each other for investors' capital, Chart A below shows there has been a strong long-term relationship between stock and bond yields.

Chart A: 10 Year Treasury Yields vs. S&P 5000 Earnings Yields



Assuming this relationship holds in the future, the current stock market valuation implies that the 10-year Treasury bond will revert from its current 1.8% yield up to its 50-year historical average of 4.5%. This is quite a leap considering the 30-year bond in the U.S., Germany, and Japan are 2.4%, 1.1%, and 1.1% respectively. If instead, the 10-year U.S. Treasury bond only goes up to 3.3% (It's 10-year average), this would imply a justified market appreciation of 27%. While these numbers are just illustrative, we do believe this stock-bond relationship will continue and that lower interest rates justify higher stock valuations going forward.

Table B below shows the implied gain or loss of the S&P 500 based on different interest rate levels. Our conclusion is while interest rates may go up a bit, they should remain relatively low and thus justify higher stock prices and could act as a tailwind over the next few years as investors digest the implications of a perpetually lower interest rate environment.

Table B: 10-Year Treasury Yield Implied Stock Valuations

Interest Rate Level (frame of reference)	Low (Current)	Middle (10-yr Avg)	Historical Avg (50-year avg)	High (1990-1995 avg)
10-Year Treasury Bonds Rate	1.8%	3.3%	4.5%	7.0%
Implied S&P 500 Earnings Yield	3.2%	4.3%	5.1%	6.8%
Equivalent S&P 500 PE Ratio	31	24	20	15
Implied S&P 500 Gain/(Loss)	68.1%	27.1%	6.4%	-20.6%

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